Government Contracts Advisory

December 6, 2010

D.C. Circuit Clarifies False Claims Act Damages and "Collective Knowledge" Standards, but Complicates "Implied Certification" Test

On December 3, 2010, the U.S. Court of Appeals for the D.C. Circuit issued its much- anticipated opinion in *United States v. Science Applications Int'l Corp ("SAIC")*, **No. 09-5385**. (Slip Op.). The unanimous opinion is an important False Claims Act (FCA) decision in at least three respects. First, it embraced a relatively broad "implied certification" theory of civil FCA liability for the D.C. Circuit. Second, and despite its broad holding on implied certification, the opinion stated that a corporate entity may not be found to possess the requisite knowledge for an FCA violation on the basis of a "collective knowledge" theory that pools the knowledge of all of the corporate entity's employees. Third, the D.C. Circuit held that the value of goods or services provided under a contract must be considered when assessing FCA damages, rejecting the government's argument that advisory services found to be tainted by an undisclosed conflict of interest were *per se* valueless.

Background

The case arose out of a pair of contracts held by SAIC for consulting services to be provided to the Nuclear Regulatory Commission (NRC). Among other things, the NRC contracts included provisions relating to SAIC's potential or actual organizational conflicts of interests ("OCI"), such as a limitation on SAIC's ability to "work for others" during the contract term. The contract also required SAIC to certify that it had no OCI, and to immediately disclose potential conflicts if they were discovered after contract award. SAIC's contract did not require it to make these certifications each time it sought payment but rather to request payment using pre-printed vouchers which contained no certifications relating to this issue. While performance was underway, during an open NRC meeting in October 1999, a member of the public alleged that SAIC was in violation of these contractual provisions. The NRC requested information regarding these allegations; SAIC responded by disclosing its existing contracts with two other companies in the nuclear field. After determining that SAIC had violated the conflict-of-interest provisions in its contracts, the NRC terminated SAIC's contracts. Notwithstanding that action, the NRC continued to use the SAIC work product delivered under the contracts.

Subsequently, the Justice Department brought suit against SAIC alleging two claims under the civil FCA and one claim for breach of contract. The government's allegations relied on an "implied certification" theory of FCA liability, alleging that SAIC was liable even though its invoices did not certify compliance with the OCI provisions of the pertinent contracts and compliance with the OCI provisions was not an express condition precedent to payment under the contracts. In *United States v. Science Applications Int'l Corp.*, 555 F. Supp. 2d 40, 49-51 (D.D.C. 2008), the district court allowed the government to go forward with this theory of liability. Following a four-week trial, a jury found SAIC liable under the FCA, and also liable for breach of contract. On the breach of contract claim, the jury awarded damages of $78. Based on the court's damages instruction, however, the jury assessed FCA single damages of $1,973,839.61, the full amount of all payments made to SAIC by the government under the contracts. Pursuant to the FCA, this amount was then trebled, and added by the district court to $577,500 in civil FCA penalties, for total damages of $6,499,096.83.

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Following the jury verdict, SAIC moved for judgment as a matter of law or, alternatively, for a new trial, arguing (1) the government failed to prove its implied certification theory because the record contained no evidence that payment was expressly conditioned on compliance with the contract's OCI provisions; (2) that the evidence precluded the jury from finding SAIC liable because of SAIC's reasonable belief that it had no conflicts as defined by the applicable contractual provisions and regulations; (3) that the jury instructions were erroneous and prejudicial, including one instruction that the jury could find that SAIC possessed knowledge based on the "collective knowledge" of its employees; and (4) that the government failed to prove that it suffered any damages from SAIC's false claims, and that the district court's damages instruction was erroneous and prejudicial. In *United States v. SAIC*, 653 F. Supp. 2d 87 (D.D.C. 2009), the district court rejected each of SAIC's arguments, setting the stage for SAIC's appeal.

The D.C. Circuit's Opinion

The D.C. Circuit affirmed the judgment on breach of contract but vacated the FCA judgment and remanded the case to the district court for further proceedings. The opinion is very significant for government contractors because of its three central holdings: (1) the D.C. Circuit endorsed the "implied certification" theory of FCA liability and held that an implied false certification is established where the government shows "that the contractor withheld information about its noncompliance with material contractual requirements"; (2) the court rejected the "collective knowledge" theory of FCA scienter adopted by the district court; and (3) the D.C. Circuit also rejected the district court's damages instruction, which precluded the jury from considering the value of services that SAIC had provided to the NRC.

Implied Certification

SAIC argued to the D.C. Circuit that FCA liability based upon a false "implied certification" should attach "only where a statute, regulation, or contractual provision makes compliance with a requirement an express condition precedent to payment." In contrast, the government asserted that implied certification liability could extend to any situation in which the government contractor "submit[ed] claims for payment while knowing that it violated contractual provisions that are material to the government's decision to pay." The D.C. Circuit settled on a position closer to the government's, opining:

[W]e hold that to establish the existence of a "false or fraudulent" claim on the basis of implied certification of a contractual condition, the FCA plaintiff—here the government—must show that the contractor withheld information about its noncompliance with material contractual requirements. The existence of express contractual language specifically linking compliance to eligibility for payment may well constitute dispositive evidence of materiality, but it is not, as SAIC argues, a necessary condition. The plaintiff may establish materiality in other ways, such as through testimony demonstrating that both parties to the contract understood that payment was conditional on compliance with the requirement at issue. (Slip. Op. at 18)

The D.C. Circuit took pains in the opinion to emphasize the importance of the materiality and scienter requirements for FCA liability, stating these principles were important limits on the reach of the "implied certification" theory.

Collective Knowledge

In the district court proceedings, the government urged the court to adopt a "collective knowledge" approach to the FCA requirement that a contractor "know" its claims or statements are false, through actual knowledge, reckless disregard or deliberate ignorance. The district court agreed and instructed the jury that it must consider "the knowledge possessed by those employees and agents as if it was added together and combined into one collective pool of information."

The D.C. Circuit rejected the lower court's approach, noting that no circuit court in the country had applied this "collective knowledge" theory to the FCA. The appeals court found that the collective knowledge theory would allow "a plaintiff to prove scienter by piecing together scraps of 'innocent' knowledge held by various corporate officials, even if those officials never had contact with each other or knew what others were doing in connection with a claim seeking government funds." The circuit court added that the district court's collective knowledge instruction "allowed the jury to impose liability for what is essentially negligence or mistake by another name." Because of this error by the district court, the D.C. Circuit vacated the lower court's judgments with respect to the two FCA claims.

FCA Damages

Finally, the D.C. Circuit rejected the district court's FCA damages instruction. The district court directed the jury to determine what the NRC paid to SAIC "over and above what the NRC would have paid had it known of SAIC's

organizational conflicts of interest." In making that calculation, however, the jury was instructed *not* to consider the value of the services that SAIC had provided to the NRC under the contract, despite evidence at trial that the NRC had used SAIC's work product after terminating the contract for OCI violations. The D.C. Circuit observed that this instruction "compelled the jury to assess as damages the actual amount of payments the government made to SAIC." Instead, the D.C. Circuit said, damages should be calculated under the long-standing test for damages first articulated in *United States v. Bornstein,* 423 U.S. 303 (1976): "'the difference between the market value of the [product] it received and retained and the market value that the [product] would have had if [it] had been of the specified quality.'"

Implications and Predictions

Broadly speaking, the "implied certification" theory of FCA liability articulated by the D.C. Circuit in *United States v. SAIC* places a premium on government contracting compliance. Contractors should now understand that DOJ may allege liability under the FCA for *any* non-compliance with a "*material*" provision of their contract. Although the D.C. Circuit contrasts such "material" contract provisions with "provisions that are merely ancillary to the parties' bargain, it provides no framework to distinguish a "material" contract provision from a "minor" or "ancillary" contract provision. Moreover, it ignores completely the practical and legal difficulty of making such determinations at trial. While government contract case law dealing with "strict" and "substantial compliance" may well not be applicable, it has long been noted that "[t]he government is generally entitled to enforce strict compliance with contract requirements." *See* Nash, Cibinic & Nagle, *Administration of Government Contracts,* p. 815 (4th ed. 2006).Potential FCA plaintiffs and the Justice Department can be expected to seize upon this language to argue that no provision in a government contract is minor or ancillary, and therefore a "knowing" violation subjects the contractor to FCA liability. *But see United State ex rel. Owens v. First Kuwaiti General Grading & Contracting Co*., 612 F.3d 724, 734 (4th Cir. 2010) (holding FCA does not extend to run-of-the-mill breach of contract actions).

In this opinion, the D.C. Circuit stressed the importance of the "materiality" requirement as a limiting principle on the reach of the "implied certification" theory. In 2009, Congress revised the FCA through the Fraud Enforcement and Recovery Act ("FERA") to codify the definition of "materiality" as "having a natural tendency to influence, or be capable of influencing," the contracting officer's payment decision. That subjective standard (which is arguably far less restrictive than the D.C. Circuit's rule in this case), coupled with potential liability for false certifications implied from a knowing violation of contract, presents two significant risks for government contractors.

First, the D.C. Circuit's rejection of the concept that the implied certification theory should be limited to violations of express conditions precedent to payment in the contract drives the liability decision away from an objective standard determined by a court, to a subjective decision that, in many cases, will be made by the jury. This not only increases litigation risk in implied certification cases, but reduces opportunities for summary judgment as well.

Second, the D.C. Circuit's standard for implied certification theory, as a practical matter, can be expected to further blur the line under the FCA between breach of contract and fraud. With the benefit of hindsight, an enormous number of standard government contract terms and conditions can be deemed "material" to the government. Contractors can expect to see more FCA complaints predicated on what are, essentially, breach of contract allegations.

It is possible (but not likely) that Congress may act to amend the False Claims Act in the wake of this decision. However it is not clear how the politically divided 112th Congress will approach FCA reform generally, nor the implied certification issue specifically. More likely is the possibility of an appeal. Either party may choose to seek *en banc* review of Friday's opinion by the full D.C. Circuit, or seek review of the case by the Supreme Court. In this opinion, written by Judge David Tatel and joined by Chief Judge David Sentelle and Judge Thomas Griffith, the D.C. Circuit devoted nearly two pages of its 39-page opinion to the "unsettled" state of the circuit law on the "implied certification" theory of the FCA . This discussion may signal the panel's hope that the issue be revisited by the full D.C. Circuit sitting *en banc*, or by the U.S. Supreme Court.

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